Mexico

Negotiated M&A Guide[1]

Corporate and M&A Law Committee

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1. Introduction

Generally speaking, the Mexican legal framework applicable to agreements that would fall within the scope of a merger and acquisition transaction are several; some are those you would expect from a civil law based legal system (as opposed to common law jurisdictions), but other relate specifically to the industry or sector of the Mexican companies involved in the transaction, whether as purchasers, sellers, targets or affiliates of any of the foregoing.

Just to name a few, practitioners should initially focus on the local Civil Code (*Código Civil*) that applies to the location of the company or assets being acquired, the Code of Commerce (*Código de Comercio*), the General Law on Commercial Companies (*Ley General de Sociedades Mercantiles*), the Securities Markets Law (*Ley del Mercado de Valores*), the National Foreign Investment Law (*Ley Nacional de Inversión Extranjera*) and the Federal Law of Economic Competition (*Ley Federal de Competencia Económica*) as well as any regulations or other provisions that are related to the foregoing. Naturally, special analysis and consideration needs to be given to applicable tax provisions that affect the investment structure before and after the acquisition. For purposes hereof, we will focus on the General Law on Commercial Companies (the "GLCC"), the Securities Market Law ("SML"), the Foreign Investment Law (the "FIL") and the Federal Law of Economic Competition (the "Competition Law").

The distinction between commercial and civil transactions must be continually borne in mind. The Code of Commerce contains special rules governing commercial contracts, the principal purpose of which is to simplify the conduct of business. Pursuant to the Code of Commerce the parties to a commercial agreement are bound in the manner and terms upon which they appear to have obligated themselves and the validity of commercial transactions does not depend upon the observance of definite formalities and requisites except: (i) in cases where the civil or other commercial laws require agreement to be in form of public document (*i.e.*, articles of association of a Corporation or other legal entity, the transfer of real estate assets, long term leases) or where special formalities are required to render the agreement enforceable (*e.g.*, bills of exchange or registration in the corporate books of Mexican entities in case of transfers or liens over equity interests issued by a Mexican entity); and (ii) in agreements executed in foreign countries, which must comply with formalities required in the country of their execution regardless of whether or not such formalities are required in Mexico. Having said that, counsel should take special note that certain provisions of civil law that civil contracts as they relate to capacity of parties, exceptions and causes which rescind or invalidate contracts, are also applicable to commercial contracts.[3]

Although civil codes of the different States generally follow the Federal Civil Code (*Código Civil Federal*), reference is made above to Civil Codes of the local jurisdictions because provisions of local law under such Civil Codes with regard to the interpretation of contracts, performance and extinction of obligations, rescission, as well as other local provisions governing contracts such as asset sales, leases and guarantee agreements sometimes do have certain local requirements or provisions that are different than those set forth in the Federal Civil Code.

(a) The General Law on Commercial Companies

The GLCC is a Federal law that contains a complete set of rights of shareholders of a corporation (*Sociedad Anónima* or *SA*). A foreign investor must be aware that several provisions of the GLCC are not alike to provisions applicable to corporations in the common law countries and many other jurisdictions. Accordingly, a foreign investor should be advised by counsel of the main differences of the legal systems between Mexico and its country of origin. Hereinafter, we provide examples of differences between the US and Mexican legal systems.

Under the GLCC, all the holders of the same class of stock have equal rights.[4] Pursuant to the GLCC, the shareholders and not the Board of Directors has the authority[5] to alter the organization,

[3] Articles 78, 79 and 81 of the Code of Commerce.

[4] Article 112 of the GLCC.

[5] Articles 178 and 182 of the GLCC.

structure, purposes and capital structure of the company; moreover, the shares to be redeemed must be (i) redeemed on a prorata basis for all shareholders, or (ii) selected at random through a formal lottery process.[6] Such rules on redemptions may only be by-passed by the unanimous consent of all shareholders. Under the GLCC, no resolution may be adopted against the shareholders of a given class, without a prior resolution of the holders of such class of shares at a Special Shareholders' Meeting.[7]

If the target company is listed (or it is envisioned that it will be listed in the future), in the Mexican Stock Exchange, then the foreign investor should also pay special attention to the SML which will also apply.

Although the GLCC contemplates six different forms of commercial entities,[8] the most widely used (including for the establishment of joint ventures) are the capital stock corporation (*Sociedad Anónima* or *SA*) and the limited liability company (*Sociedad de Responsabilidad Limitada* or *SRL*). These companies' main characteristics are the following:

(i) except for specific cases under which shareholders or partners may have joint and several liability with the entities, both are limited liability entities, insulating their shareholders or partners from liabilities at the entity level.[9]

(ii) the supreme decision making authority of each entity resides with the shareholders and the partners acting through the Shareholders' Meeting or the Partners' Meeting.[10]

(iii) management of these entities may be vested in a Board of Directors or Managers; a sole administrator may be designated instead too.[11]

Despite the aforementioned similarities, the Corporation (including the a type of corporation known as *Sociedad Anónima Promotora de Inversión* or *SAPI*), which is a form of entity that places greater emphasis on capital contributions rather than on the identity and continued involvement of those making such contributions, is better suited for investments or joint ventures involving two or more parties, where the parties in question seek to pool capital and financial resources rather than expertise or know-how. Conversely, where the identity of the partners and their continued participation in the entity is an integral part of the joint venture, the Limited Liability Company would be the ideal vehicle in Mexico, as it is better prepared to deal with transfer restrictions and similar arrangements. Finally, when selecting the most convenient form of joint venture company or investment vehicle –either a Corporation or a Limited Liability Company- in Mexico, foreign counsel should also analyze whether in their respective jurisdictions any one of the forms available in Mexico is entitled to a preferential tax treatment. For example, it is our understanding that US "check the box" treasury regulations distinguish between "partnerships" (pass-through entities) and "corporations" (non pass-through entities) for federal tax purposes. In such regard – as we have been informed-, Treasury regulation number 301.7701-2(b)(8) issued by the U.S. Internal Revenue Service (IRS) sets forth a list of foreign entities which shall be considered as "per se corporations". In such list the Corporation is included (and with it, the SAPI which is a kind of Corporation). Based on the foregoing, the Limited Liability Company may "check the box" as a "partnership", if it fulfills all U.S. tax legal requirements and thus be considered as a pass-through entity for U.S. tax purposes. Additionally, Mexico is a party to a considerable number of tax treaties to avoid double taxation that may contain specific provisions useful to the investor.

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[6] Articles 135 and 136 of the GLCC.

[7] Article 195 of the GLCC.

[8] Article 1 of the GLCC.

[9] Articles 82 and 58 of the GLCC.

[10] Articles 178 and 77 of the GLCC.

[11] Articles 142, 143 and 74 of the GLCC.

(b) <u>Securities Markets Law and recent reforms to GLCC</u>

Before the new SML was enacted in 2005[12] and recent reforms to the GLCC were passed, schemes used in the United States or other countries, such as shareholder agreements, voting covenants, transfer restrictions, cashouts or exchange of common stock for other securities, were limited by the GLCC. Consequently, provisions generally used by private equity investors such as voting agreements, lock-ups, calls, puts, repurchases or redemptions, drag-alongs, tag-alongs, registrations rights and squeeze-outs of minority shareholders were difficult to efficiently achieve and enforce in a cost effective manner that carried an acceptable risk to the investor.

Fortunately, since 2005, the SML has contemplated the *sociedad anónima promotora de inversion*, or "SAPI," which was designed to accommodate private equity investments, and serve as a transition from a closely-held corporation into a publicly-traded company; although it has also proven to be a very useful investment vehicle for strategic joint ventures. SAPIs are closely-held corporations, and therefore their shares need not be registered before the National Securities Registry (*Registro Nacional de Valores*) or listed on any stock exchange, and they are not subject to compliance provisions or the supervision of the Mexican Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*).

One of the most important aspects of the SML is that it expressly recognizes the validity and effectiveness of shareholders' agreements among the shareholders of a SAPI.[13] This allows the shareholders to establish their arrangements without the need to replicate the relevant agreements and undertakings in the SAPI's by-laws, which are available to the public through the commercial registry of the company's corporate domicile; a situation that certainly reduces confidentiality issues that investors sometimes have when the vehicle is a Limited Liability Company. Recent reforms to the GLCC[14] have generally replicated into the regulation applicable to the *Sociedad Anonima* or *SA* the same provisions set forth in the SML for SAPIs with respect to shareholders agreements and their validly and effectiveness,

Moreover, the SML and the recent reforms to the GLCC exempts SAPIs and SAs from the application of certain restrictive provisions of the GLCC allowing their shareholders to execute shareholders' agreements wherein they freely negotiate investment and governance arrangements otherwise prohibited or limited under the GLCC for Limited Liability Companies. Specific exemptions to the GLCC include:

(i) *<u>Classes of Shares</u>*. SAPIs and SAs may issue common shares, shares with limited or no voting rights (without the need of granting the holders of the latter a preferential right to receive distributions), preferred shares and shares granting preferential voting or other rights to their holders.[15] In this respect, the SML and the recent reforms to the GLCC have given investors a tool that acknowledges that different shareholders have different needs, objectives and expectations for managing their investment and its return.

(ii) *<u>Voting Restrictions</u>*. Shareholders of SAPIs and SAs may establish voting restrictions otherwise prohibited under the GLCC. Hence, the SML and the recent reforms to the GLCC allow shareholders to covenant to vote or abstain from voting on certain matters or under certain circumstances. Likewise, shareholders of SAPIs and SAs may assign their voting rights.[16]

(iii) *<u>Preemptive Rights</u>*. Shareholders of SAPIs and SAs may waive or assign their preemptive rights to subscribe and pay capital increases, even prior to the adoption of the

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[12] In the understanding that the SML was enacted on December, 2005 and became effective on June, 2006.

[13] Article 16 (VI) of the SML.

[14] On June 13, 2014 several reforms to the GLCC were published in the Official Gazette and most of them became effective on June 14, 2014.

[15] Article 13 (III) of the SML and Article 91 (VII)(c) of GLCC.

[16] Article 13 (III) of the SML and Articles 91 (VII) and 198 (III) of GLCC.

shareholders resolution approving the relevant capital increase.[17] The relevant provisions also allow for the implementation of punitive dilution and other remedies for shareholders defaulting on their capital commitments or capital calls.

(iv) *Transfer Restrictions*. The SML and the recent reforms to the GLCC applicable to SA specifically contemplate the right of shareholders to establish lock-up periods, rights of first refusal, rights of first offer, as well as tag-along and drag-along rights.[18]

(v) *Liquidity/Exit*. SAPIs (as opposed to SAs and Limited Liability Companies) are not restricted from repurchasing their own shares, which in terms of liquidity or exit allows the shareholders to put their shares to the actual SAPI.[19] The restriction from repurchasing their own shares is one of the few limitations applicable to SAs that were not eliminated by the recent reforms to the GLCC.[20] Therefore, in addition to the lower threshold applicable for minority rights in SAPIs (explained below), the restriction to repurchase their own shares is one of the few distinctions between SAs and SAPIs. Shareholders of SAPIs and SAs may establish specific registration rights designed to take the SAPI or the SA public, as well as put and call mechanisms among the shareholders.[21]

(vi) *Non-Compete*. Subject to the Competition Law and its regulations (and other enforceability questions under the Mexican Constitution), shareholders of SAPIs and SAs may establish non-compete provisions or exclusivity covenants.[22]

(vii) *Dispute Resolution*. The shareholders of a SAPI or a SA may establish dispute resolution mechanisms, including mechanisms triggered by fundamental business disagreements that trigger buy-sell schemes.

In terms of minority rights, the SML establishes minority rights and protections for SAPI's shareholders that are similar to those that apply to publicly-traded companies. Among other rights, the SML lowers thresholds for the appointment of directors and statutory auditors from 25% under the GLCC, to 10%.[23]

SAPI's are given the option to adopt (even gradually) the corporate governance provisions applicable to publicly traded companies.[24] SAPI's that elect to adopt the corporate governance standards of listed companies will be subject to the more stringent governance schemes. Among others, in terms of corporate governance the SML specifies the authority and duties of the Board of Directors and the Chief Executive Officer of a listed company, and contemplates certain standards that are novel to Mexico, such as the standard of loyalty, the standard of diligence and the business judgment rule.[25]

Finally, when considering a minority interest investment in Mexican companies or a joint venture with a Mexican group of shareholders, foreigners should note that the GLCC imposes very limited obligations on a Company in terms of preparing and delivering financial and operating information to the shareholders or partners. Shareholders or partners have a statutory right to inspect the financial information (including Balance Sheet, Income Statement, Statement of Changes in the Stockholders' Equity and Statement of Changes in the Financial Situation) just before the fiscal year's results are to be submitted to them for approval or at the annual Shareholders' or Partners' Meeting.[26] Accordingly, any

[17] Articles 13 (V) and 16 (IV) of the SML and Articles 91 (VII)(e), 132 and 198 (II) of GLCC.

[18] Articles 13 (I) and 16 (VI)(b) of the SML and Articles 91 (VII)(a) and 198 (I) of GLCC.

[19] Article 17 of the SML.

[20] Article 134 of GLCC.

[21] Article 16 (VI) (b) and (e) of the SML and Article 198 (I) and (IV) of GLCC.

[22] Article 16 (VI) (a) of the SML.

[23] Article 16 (I) and (II) of the SML.

[24] Article 29 of the SML.

[25] Articles 28 and 29 of the SML.

[26] Articles 172 and 173 of the GLCC.

person negotiating a joint venture in Mexico should place great emphasis on specifically outlining in the by-laws (and/or in the shareholders' agreement) not only the nature of the information that the investment vehicle should produce and deliver, but also the process that must be followed by the parties in order to inspect books and records and to access the company's facilities and management, so as to ensure that it will have full access to the company's information.

(c) Foreign Investment Law

The FIL governs foreign investment in Mexico and imposes certain limitations and restrictions on the percentage of the voting capital stock of Mexican corporations or assets which may be owned by non-Mexican nationals depending on the industry and business sector in which such companies are involved or in which the assets are used. The Foreign Investment Commission (the "FIC") is the administrative body in charge of enforcing the FIL.[27]

For purposes of the FIL, an investor will qualify as a "Mexican investor" if he/she is a Mexican national or an entity incorporated and existing in accordance with the laws of Mexico, of which at least 51% of the voting stock or capital is owned by Mexican nationals[28] (*i.e.*, a Mexican company that of which more than 49% of the voting stock is owned by non-Mexican investors, would be deemed a "foreign investor" under the FIL).

In general, under the FIL, foreign investors may invest in both listed and unlisted Mexican companies, subject to a limited number of restrictions on investment in certain economic sectors (see below) which are, under the Law, specifically reserved to Mexican nationals and/or the Mexican Government.[29] Thus, foreign investors need to take foreign investment laws and its regulations into account during the initial phase of any project in order to ascertain that the investment in any given sector is viable.

As a result of a landmark amendment to the Mexican Constitution in December 2013 the Mexican energy sector changed completely by opening the hydrocarbons sector to private investment after having been under State control for more than half a century. The Energy Reform aims to overhaul Mexico's energy industry by allowing private investment not only in Exploration and Extraction activities (E&P projects) but also in refining, natural gas processing, industrial transformation, transportation, distribution, storage and retail of liquid fuels, natural gas, petrochemicals and the power sector. Consequently the FIL was amended to allow private investment.[30]. Although foreign investment is allowed to participate in Mexico´s energy industry, the entities holding contracts, permits and authorizations must be constituted Mexican entities.

The Energy Reform provides that the Mexican State shall undertake oil and other hydrocarbons E&P projects through State productive companies (i.e. *Petróleos Mexicanos*; PEMEX) or through contracts awarded to private companies. As a result, the long-standing state monopoly in the oil, gas and petrochemical came to an end, opening all areas of each sector to private investment.

The Federal Electricity Commission (*Comisión Federal de Electricidad;* CFE) has also been transformed into a State productive company and went through a deep reorganization of its subsidiaries which entailed the transfer of the appropriate assets, rights, obligations, resources, operational profits and rates income that are required by each of CFE's subsidiaries for the execution and development of its main activity and purpose. The Energy Reform eliminated the historic restrictions imposed to private entities and individuals regarding their participation to generate power, by not considering such activity as a public service for its direct sale or to end-users. As a consequence of the implementation of the Energy Reform, more than 60 contractual areas for E&P projects have been awarded and 3 short and long term

[27] Article 2 of the FIL.
[28] Article 8 (III) of the FIL.
[29] Articles 5 and 6 of the FIL.
[30] Articles 5 and 6 of the FIL.

auctions on the wholesale electricity market have taken place bolstering private and foreign investment for an amount of more than USD100 billion for the next 10 years.

Other areas -such as ground transportation- are reserved to Mexican investors exclusively. In a nut shell, foreign investment is accepted up to 100% in companies and activities not subject to specific foreign ownership limitations in certain sectors, including the following:

(i) Up to 10% cooperative associations of productions;[31]

(ii) Up to 49% foreign investment in companies that manufacture and sell explosives and firearms, print and publish national newspapers, issued Series "T" shares and hold an interest in land for agriculture, forestry or livestock, are involved in fishing activities (except aquaculture), port administration and others. The referred limitation on foreign participation may be not exceeded directly or indirectly through trusts or other agreements or through indirect foreign participation;[32]

(iii) A favorable resolution by the Foreign Investment Commission is required so that foreign investment may exceed a 49% participation in shipping companies, air terminals, legal and education services;[33]

(iv) Other than such specific limitations on foreign investment participation, the FIC needs to approve, also, any proposed investment by foreigners in a company whose assets are worth approximately $16,816,000,000 Mexican pesos (approximately US$943,140,000) or more.[34]

The FIL allows foreigners to either own majority economic interests in Mexican companies operating in sectors or industries where foreign investment is restricted to a maximum aggregate percentage (see above), or to obtain funding from foreign sources in the form of new equity without exceeding the applicable foreign investment thresholds and without forfeiting Mexican control of the company in question. It does so through a concept known as "neutral investment" (*inversión neutra*) or "neutral shares" that is specifically provided for and governed by the FIL and its regulations (*Reglamento de la Ley de Inversión Extranjera*). "Neutral investment" is defined as the investment made in a Mexican company or trust which is not computed for purposes of determining the percentage of foreign investment in the equity of the company.[35]

A Mexican company may only issue non-voting or limited-voting shares which qualify as neutral investment ("Neutral Shares") with the prior authorization of the *Secretaría de Economía* (Ministry of the Economy) and, in case the issuer of the Neutral Shares is or will be a public company under applicable securities laws, the *Comisión Nacional Bancaria y de Valores* (Banking and Securities Commission). To obtain such an authorization, the Mexican company, that is, the issuer of the Neutral Shares, must file a written application before the Ministry of the Economy, specifically referring to the sector in which the company operates, and stating the business rationale for having Neutral Investment, as well as the rights and obligations which will attach to the Neutral Shares (*e.g.*, matters with respect to which the shares would be entitled to vote, if any, preferred distributions; etc.).[36]

The FIL and the Regulations do not specifically provide for a maximum or minimum percentage of Neutral Investment. Hence, the Ministry of the Economy has discretionary authority to determine, on a case by case basis, the aggregate percentage of Neutral Shares that may be issued as a percentage of

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[31] Article 7 of the FIL.

[32] Article 7 of the FIL.

[33] Article 8 of the FIL.

[34] Information provided by means of *Resolución General que determina el monto actualizado del valor total de los activos a que hace referencia el artículo 9o. de la Ley de Inversión Extranjera*, published in the Federal Official Gazette on March 29, 2017.

[35] Article 19 of the FIL.

[36] Articles 18 and19 of the FIL; Article 23 of the Regulations of the FIL.

total equity represented by common stock (*acciones ordinarias*). In considering applications, and specifically the reasonableness or appropriateness of the percentage of Neutral Investment requested in any given application, the Ministry of the Economy will take into account, among other factors, whether the Neutral Shares will be non-voting or limited-voting.[37] To the extent that Neutral Shares will be non-voting shares, the Ministry of the Economy has generally authorized a larger proportion of Neutral Investment. During the application process, the Ministry of the Economy will request the opinion of the industry regulator to determine the appropriate and permissible level of Neutral Investment.

(d) Federal Law of Economic Competition

Mexico undertook a commitment to implement a real competition policy when entering into the North American Free Trade Agreement (NAFTA). Due to a recent amendment to the Constitution, the former Federal Competition Commission (the "Former FCC") was transformed into the new Federal Commission of Economic Competition (*Comisión Federal de Competencia Económica*; the "COFECE") with exclusive jurisdiction over competition issues in all areas and industries other than broadcasting and telecom sectors, and the Federal Telecommunications Institute (*Instituto Federal de Telecommunications*; the "IFT") was created as a new autonomous constitutional body with exclusive jurisdiction over competition issues in the broadcasting and telecom sectors. Both agencies, the IFT and the COFECE (the "Antitrust Authorities"), are the autonomous constitutional bodies in charge of enforcing the Competition Law and its regulations, and in doing so, preventing and investigating monopolistic practices and concentrations, whose purpose or effect is to diminish or impede free competition with respect to similar or substantially related goods.[38] The following sectors are not considered monopolies under the Competition Law: strategic areas (*i.e.*, postal service, generation of nuclear energy, petroleum and hydrocarbons, electricity); activities of the Central Bank of Mexico; unions; and privileges derived from intellectual property rights and copyrights.[39] As a result of the above mentioned Constitutional Amendments, on July 7, 2014, a completely new Federal Economic Competition Law (*i.e.*, the Competition Law), became effective , abrogating the former competition law.

The Competition Law addresses merger review under the name of concentrations (*concentraciones*), which not only involve mergers but also acquisitions or any other similar act that combines corporations, associations, partnerships, shares of stock, assets or trusts between competitors, suppliers, customers or any other economic agents.[40] In view of the foregoing, foreign investors must take note that the Antitrust Authorities may block any given transaction if it "creates or strengthens a dominant position as a result of which effective competition would be significantly impeded in the Mexican market or in a substantial part of it".[41] Although all concentrations which occur in Mexico or have effects in Mexico are subject to the Competition Law and may be investigated by the Antitrust Authorities, the Competition Law sets forth the following notification thresholds[42] (pre-merger fillings) which trigger the obligation of economic agents to notify concentrations before they are undertaken:[43]

(i) if the transaction or series of transactions that give rise to the concentration, notwithstanding the place of execution, represent within Mexico, directly or indirectly, a value greater than MX $1'358,820,000 pesos (approximately US $75.49 million[44]);[45] and/or

[37] Article 20 of the FIL.

[38] Article 2 of the Competition Law.

[39] Article 64 of the Competition Law.

[40] Article 61 of the Competition Law.

[41] Article 62 of the Competition Law.

[42] The monetary thresholds are calculated based on the equivalent in pesos to the general Measure Unit (*Unidad de Medida y Actualización*, the "Measure Unit"). The value of each Measure Unit for year 2017 is MX$75.49 pesos. Within the first 10 days of every year, the value of each Measure Unit should be published in the Official Gazette. The Measure Unit is an economic index to quantify and determine the payment of obligations and duties provided in federal laws. The value of the Measure Unit for each year is available in the following link: http://www.inegi.org.mx/est/contenidos/proyectos/uma/default.aspx.

[43] Article 86 of the Competition Law.

[44] At an exchange rate of MX $18.00 pesos per US Dollar.

[45] This refers to the price allocated to Mexico, as per the relevant agreement between the parties. If there is no purchase price allocated to Mexico, this threshold is not applicable to the proposed transaction. However, thresholds ii) and iii) must be analyzed.

(ii) if the transaction or series of transactions giving rise to the concentration, result in the acquisition of 35% (thirty-five percent) or more of the assets or shares of an economic agent whose total assets or annual sales located/originated in Mexico are worth more than MX $1'358,820,000 pesos (approximately US $75.49 million); and/or

(iii) if the transaction results in (1) an accumulation within Mexico of assets or capital stock in excess of MX $634'116,000 pesos (approximately US $35.22 million), and (2) the assets located in Mexico or annual volume of sales originated in Mexico of the economic agents involved in the concentration, jointly or separately, are worth more than MX $3'623,520,000 pesos (approximately US $201.306 million).

It is important to point out that a transaction will be subject to a pre-merger filing by reaching at least one of the abovementioned thresholds. Likewise please note that if the thresholds are not met, the Antitrust Authorities may still have the right to analyze the transaction.[46]

In Mexico, the merger review process is suspensory in all cases; thus, the parties cannot close their transaction prior to receiving clearance by the Antitrust Authorities.[47]

2. Structure of the Transaction

Generally speaking, a purchaser of a business in Mexico has two options: stock acquisition versus asset acquisition. There is no specific rule of thumb as to what is more convenient, because both structures have their specific issues that need to be addressed prior to and during the negotiation process. The convenience of one form of acquisition over the other depends mainly on four factors: (i) confidence in, and reliability of the information supplied or to be supplied by the sellers and the target company, particularly as it relates to liabilities and contingencies; (ii) scope and accuracy of the sellers' representations and warranties; (iii) creditworthiness of the sellers as indemnifying parties under the purchase agreement; and (iv) the business sector and industry in which the target and its subsidiaries operates and the nature and number of the assets which conform such target's business.

To the extent the purchaser has confidence that the information supplied by the sellers and the target is reliable and it is accorded the right to thoroughly diligence such information and any liabilities of the target, a *stock purchase* would be the faster and preferred way to acquire existing businesses in Mexico. Having said that, due note should be taken that an asset purchase transaction would allow the buyer –unless otherwise agreed to in the asset purchase agreement- to acquire the assets free and clear of any liabilities, except for those relating to tax and labor, which liabilities would follow the assets as explained above.

As you will see in the list below, issues that arise from an acquisition in Mexico are generally the same as those of other jurisdictions; however, we believe it is an important exercise that will give foreign counsel a heads-up on the most relevant issues that arise in a stock and/or asset acquisition in Mexico:

(i) _Political Issues / Public Opinion_. Although steps have been take in the right direction since the mid 1990's, many sectors and industries are still politically charged and, because of it, subject to public opinion which may increase national pride or other political issues when it is known that the control and operations of target will be assumed by a foreign company. Possible problems where direct lobbying could proof useful include issues with raw material suppliers and service providers, unionized employees, officials of all levels of government, industry chambers, etc.

(ii) _Regulatory Permits_. Another important consideration when deciding upon an asset acquisition versus a stock acquisition and that is intimately related with the "Political Issues"

[46] Article 65 of the Competition Law.
[47] Article 87 of the Competition Law.

briefly described above is the regulatory aspects applicable to the target's businesses. Many permits, licenses, concessions and authorizations granted by the Mexican governmental authorities to companies for carrying out their business are non-transferable; thus, buyers of a target's asset (rather than its shares) whose activity is highly regulated should take into consideration the timing issues, complexity and additional costs of obtaining the necessary permits and authorizations to carry on the business once the asset acquisition has been agreed upon and/or completed. Considering that obtaining such regulatory permits and authorizations are a standard condition to closing of any purchaser in an asset acquisition, it is in the best interest of both parties to jointly collaborate during the pre-closing period in not only managing public opinion but also in the sometimes more important task of assigning whatever transferable permits the seller entities have and/or in carrying out the necessary actions to obtain the remaining permits or the consents of the granting authority to carry out the transfer.

(iii) *Antitrust Approval*. As discussed in 1(d) above, under any of the two alternative structures, the prior approval of the Antitrust Authorities may be required to the extent the transaction (or series of transactions) or the parties thereto fall within the thresholds set forth in the Competition Law.

(iv) *Control/Minority Shareholders*. A stock purchase acquisition provides a higher degree of control subject, principally, to any minority shareholdings and the terms of any third party contracts. Clearly, the higher the minority interests, the greater will be the limitations on control, so minority rights and their implications to each scenario are important to determine once counsel knows the nature of provisions and rules applicable to their participation. Although the minority rights play a much smaller role in an asset acquisition, third party contracts together with the political/regulatory issues discussed in paragraphs (i) and (ii) should be carefully considered before deciding on the best approach. For example, in the context of an asset acquisition, if such assets include contractual rights (*e.g.*, suppliers, lease agreements, etc.), then the prior consent of the relevant third parties will generally be required as is the case with third party contracts with change of control provisions that would apply in a stock acquisition.

(v) *Balance Sheet and Income Statement Effects*. Important differences exist in the balance sheet and income statement effects applicable to a stock acquisition and an asset acquisition, among others, please note the following:

(1) *Balance Sheet*. In a stock acquisition, the buyer assumes all liabilities (including balance sheet, labor, covenants, contractual rights and obligations, etc.) and net operating losses and generally other tax attributes of the target will certainly remain. On the other hand, in an asset acquisition tax and labor liabilities (and claims) follow the assets, to the extent the acquisition involves substantially all of the assets of the relevant business (on-going concern).[48] Notwithstanding, please note that the tax liabilities mentioned above would be limited to (i) the value of the business that, in principle, should equal the assets' purchase price; and (ii) all penalties related to the business are excluded from such tax liability. An important consideration to certain strategic buyers is that net operating losses and other tax attributes of target are not transferable in an asset acquisition.

(2) *Income Statement*. A stock purchase made by a Mexican holding company which determines taxes under a Tax Integration basis, may grant the buyer an income tax deferral of the profits and losses of the target company and its eligible subsidiaries (that comply with the requirements applicable to the new tax integration regime). Under newly enacted tax provisions related to tax integration that will apply as of 2014, companies that opt to integrate their profits and losses will have to recapture income tax deferrals at the individual level every three years. In any event, under both scenarios the buyer will be able to depreciate the value of all assets owned by target.

[48] Article 26 (IV) of the Federal Tax Code (*Código Fiscal Federal*).

(vi) *Liabilities*. In the stock acquisition, the buyer indirectly steps into all of target's liabilities (whether contingent or otherwise) limited, of course, to its resulting equity interest in the target as of the closing date; that is, buyers' liability will be limited to and would not exceed the purchaser's equity contribution in the target that is a Corporation, a Limited Liability Company or a SAPI. On the other hand, the buyer in an asset acquisition will purchase such assets with existing liens and encumbrances (unless otherwise released on or before the closing takes place), but all liabilities of the seller, such as its covenants, contractual rights and obligations, remain with the seller, other than certain tax, environmental or liabilities that will follow the assets; for example (i) payment of any due and outstanding amount related to Property Tax (where, depending on the local tax laws, the buyer usually becomes joint and severally liable), (ii) owners and possessors of contaminated sites are responsible for their cleanup regardless of the liability of the contaminating party, and (iii) payment of due and outstanding water extraction duties.

(vii) *Bankruptcy Risk*. Depending on the current financial condition of the seller at the time of execution and until closing, stock and –particularly- asset purchase transactions must be carefully analyzed from a fraudulent conveyance point of view, as there may be certain limitations or principles to comply with under the applicable Mexican bankruptcy statutes that could affect the timing and enforceability of the transaction.[49]

(viii) *Insurance*. There is no major consideration relating to insurance coverage in Mexico in view of an asset or stock acquisition. In a stock transaction the buyers should focus on feeling comfortable with the current coverage of the target company. As in other jurisdictions, the buyer should study target's current coverage on its business and assets (including D&O, personal liability, property liability, third party liability and environmental liability insurance) so as to request the assignment of such insurance policies to the relevant beneficiary without losing coverage at any time. In an asset deal, the parties (specifically the buyer) have two options, both of which will need to be discussed with the insurance company: (i) the assignment of the policies in favor of the purchaser or (ii) cancel and rewrite the existing policies in which case the accrued premium would be taken into consideration with the outstanding premium remaining payable by the new insured person. Under this last scenario, it is important to identify any event that may have occurred during the term of the policy being cancelled so that such event is covered by the new policy.

(ix) *Tax Considerations*. The fiscal reform that was approved in 2013 and became effective in 2014 has introduced new challenges in the investment landscape in Mexico. Key aspects that investors participating in M&A transactions must be aware of are (1) dividends distributed to foreign residents and Mexican resident individuals derived from 2014 profits and onwards are now subject to a 10% withholding tax (even if they are distributed from the after-tax earnings account), noting, however that such withholding tax rate could be reduced or eliminated for foreign residents under an applicable tax treaty, (2) sales of shares through the Mexican stock exchange are now generally subject to a 10% capital gains tax in the case of Mexican individuals and non-Mexican entities and individuals (subject to certain exceptions, including double-taxation treaty exemptions), and (3) certain deductions available for individuals and corporations were reduced.

Important tax effects (and transaction costs) applicable to a stock acquisition and an asset acquisition are very different, among others, please note the following:

Stock Acquisition	Asset Acquisition
Income Tax: If sellers are Mexican companies residents for tax purposes; then, the gain resulting from the	Income Tax: If sellers are Mexican resident companies; then, the gain (sales price minus undepreciated

[49] Articles 114 and 115 of the Bankruptcy Law (*Ley de Concursos Mercantiles*).

Stock transfer will be taxable at a 30% income tax rate. Mexican resident individuals would be taxed at a progressive income tariff that may reach a 35% (top bracket). If the sellers are foreign residents the stock transfer may be taxed upon election of the seller at (i) 25% over the gross proceeds (purchase price) or (ii), 35% over the net gain subject to complying with several formalities. Certain tax treaties may provide a lower tax rate or even a tax exemption under certain circumstances. If the stock transfer is derived from a corporate reorganization tax can be deferred until the transferred stocks leave the group. Tax is paid through withholding if acquirer is a Mexican resident, otherwise foreign seller should pay by appointing a legal representative. The purchase price paid for acquiring the shares does not generate any upfront tax benefit for the buyer. Any excess received over the price paid to acquire the shares in a future transfer of the acquired stock would become a taxable event in Mexico (*i.e.*, the net gain becomes taxable then). Currently, an electronic tax invoice should be issued supporting the stock transfer if the seller is a Mexican resident or a tax invoice (that should comply with certain requirements) if the seller is a foreign resident.	balance, if any) resulting from the Asset transfer will be taxable at a 30% income tax rate. Mexican resident individuals would be taxed at a progressive income tariff that may reach a 35% rate (top bracket). The purchase price paid to acquire the assets will be the tax basis for the acquirer, and depending on the asset acquired, assets are subject to tax depreciation utilizing a straight line method. A step-up basis will be available on the purchase price paid for acquiring the asset. Any goodwill paid for the acquisition of the assets will not be deductible; thus, will not increase the depreciable tax basis of the acquirer. Electronic invoices should be issued for the acquisition of each asset or at least for each group of similar assets in order to support the depreciable tax basis of the acquirer.
<u>VAT</u>: No VAT is payable by either party for a stock purchase transaction.	<u>VAT</u>: 16% VAT payable on the assets (with certain exceptions such as land and accounts receivables). VAT may be recovered either: • in the ordinary course of business to extent acquired assets generate VAT related activities, or • by filing a reimbursement claim with the Tax Administration Service, in the understanding that VAT is not recoverable with respect of “goodwill” and the reimbursement option would not be available if the purchaser of the assets is a foreign tax resident.
<u>Local taxes</u>: No local taxes should be triggered under a stock acquisition route.	<u>Real Estate related taxes</u>: a) <u>Transfer Tax</u>: Varies from State to State and ranges from 1.5% to 3.5% of the higher of the (i) appraisal value, (ii) the recorded value in the local tax authority (cadastral value) and (iii) the purchase price. b) <u>Registration Fees</u>: The duties payable to record instrument evidencing title (or cancellation of liens) to the real estate in the relevant Public Registry of Property also varies with the location of the assets.

Other Tax Considerations: a) Transfer of stocks should be informed by target entity on an informative return (form 76- Relevant Operations) to the extent that control is being transferred.	c) Other related Fees: Fees for services rendered by real estate brokers, the notary public, the appraiser and the surveyor, if any. Other Tax Considerations: a) To the extent a foreign tax resident is the purchaser, and it continues the commercial operation of the purchased assets in Mexico, it would create a permanent establishment in Mexico for tax purposes, and therefore, be subject to Mexican taxation; thus, the convenience of incorporating a Mexican investment vehicle for the acquisition.

Finally, it is important to note that when acquiring the assets of an ongoing business concern, it is common practice in Mexico to execute a master asset purchase agreement that has ancillary conveyance documents wherein all the necessary formalities to execute and enforce the transfer of the different assets and rights of the business are duly and timely taken. For example, to the extent real estate assets are involved, a separate agreement formalized before a notary public in Mexico and registered in the applicable Public Registry of Property would be required. In addition to real estate, certain formalities must be followed when interests in long-term lease agreements or other contracts are being transferred or assigned; likewise, assets subject to liens may require separate documentation for the release (total or partial) and the subsequent transfer. As a result of the foregoing, due note should be taken that asset purchase agreements (specifically those covering a business concern) do commonly entail more transaction documentation than a stock purchase agreement, situation that may delay the drafting, negotiation and closing phases of the transaction.

With regard to a stock purchase transaction, the documentation is generally simpler and, depending on the type of entity that is the target (Corporation, Limited Liability or SAPI), counsel to the investor will need to focus on the ancillary documentation and corporate authorizations that, by statute (or pursuant to the by-laws), should be executed and delivered to document an enforceable purchase of any equity interest participation, including any required shareholder or partner approval, the approval of the Board of Directors or Managers and the waiver by existing shareholders of any right of first offer or similar right they may have. Concurrently with the foregoing, the stock acquisition needs to be recorded in the Stock Registry Book of the Company and the purchaser needs to receive original share certificates duly endorsed in property in its favor.

3. Pre-Agreement

(a) Preliminary Agreements

The execution of documents aimed to evidence the preliminary agreements of the parties and to build-up the framework in which the preparation and negotiation of a definitive agreement will be structured are common practice in Mexico. Although no specific regulation exists, these types of preparatory agreements are commonly drafted to resemble an offer, a promise to execute a definitive agreement or an atypical contract not specifically set forth in the statute (gentlemens' agreement, memorandum of understanding, head of terms agreement or other) but that generally has the same framework as the former.

The agreement whereby the parties agree to execute a definitive agreement is called a "Promise Agreement". Pursuant to the Federal Civil Code,[50] Promise Agreements evidence the agreement by means of which, in an acquisition, one of the parties acknowledges and agrees to execute a future

[50] Article 2246 of the Federal Civil Code.

agreement whereby it will sell and the other party will purchase an asset (including interests in an entity). The formalities of a promise of purchase and sale agreement are that (i) it be in writing, (ii) the basic elements of the definite contract shall be set forth (in our case, a clear identification of the asset being sold and a determined purchase price) and (iii) the parties have agreed on a specific term in which the definitive agreement will be executed. We note that Promise Agreements could trigger real estate transfer tax on some States whenever future acquirer receives possession of the assets or seller receives a part of the purchase price before a final agreement is executed. Therefore the specific legislation in which real estate property is located should be considered.

The following provisions are commonly seen in most preliminary agreements:

(i) *Due Diligence Clause.* The representatives and advisors of the parties will review, analyze and investigate relevant information and documentation pertaining to the company, its business, assets and liabilities. In most cases the purchasers will ask for reasonable access to the necessary books and records of the seller parties, the facilities and management, without interfering with the daily operations of the target company and its affiliates. It is common for due diligence tasks to be limited by the sellers to a certain period of time that is commonly tied to the exclusivity period to which reference is made below.

(ii) *No-Shop or Exclusivity Clause*. Seller assures the purchaser that there is no other on-going negotiation or existing agreement or undertaking of any kind between the seller parties and any other person with respect to the target company or its assets. Moreover sellers generally agree to give the purchaser an exclusivity period that is generally concurrent with (or longer than) the period granted to the buyer to carry out its due diligence and in which it will not make or take any competing offer or engage in negotiations of any kind with another person in connection with the company, its business or assets.

(iii) *Confidentiality Clause*. The parties need to agree on the treatment that they will reciprocally give to the other party's information or documentation they received from the beginning of the due diligence process and during negotiations. It is important that executives and officers of both parties understand that all information and documentation received during the process is confidential and that the company providing such information may have a claim against the receiving company if the unauthorized disclosure of such information occurs.

(iv) *Binding Effect Clause*. Preliminary agreements do not necessarily create a binding legal obligation to carry out the transaction therein contemplated; in most cases the documents expressly state that its content is merely an expression of mutual interest by the parties to carry on with negotiations (and the time, effort and expense of a due diligence process, in the case of the purchaser) and, if applicable, execute a definitive agreement. As a general rule, parties in Mexico tend to execute preliminary agreements of a non-binding nature wherein the only binding provisions include the confidentiality clause, the no-shop agreement and the due diligence section with the sole purpose of giving the parties additional time to clearly understand and agree on the most basic terms of the purchase transaction and its possible complexities (*e.g.*, tax and regulatory issues) that they will need to analyze before reaching a final decision and an agreement to carry-on with the deal.

A final note on the binding effect sought by either party is that special care will need to be taken by counsel of both parties to specifically set forth the intent of the parties as to the non-binding nature of the agreement and that it is only a preliminary agreement not intended to be construed or interpreted as the definitive agreement. This is especially true when the preliminary agreement has most, if not all, of the covenants and agreements of the parties that a third party would expect to find in a definitive agreement and a portion of the purchase price or the acquired assets are delivered to the other party, since pursuant to several judicial precedents the execution of a preliminary agreement with such characteristics might be considered as a definitive purchase agreement.[51]

(b) Lock-up Provisions and Voting Agreements

As discussed in Section 1(b) above when referring to the exceptions that apply to a SAPI or a SA and that are otherwise prohibited to include in the by-laws of a Limited Liability Company, lock-up or other kind of voting agreements between shareholders are permitted by the SML and the GLCC with respect to the voting rights of any shareholder of a SAPI or a SA.

Such voting arrangements between shareholders are very useful in the context of a private equity investment where the investor is acquiring a portion of the target company and will have other shareholders (whether controlling or not) whose participation the investor may want to retain (by imposing transfer restrictions to their equity interest) as part of his integral exit strategy.

4. Acquisition Agreement

For the last ten years, Mexican commercial practitioners involved in cross-border transactions have undoubtedly been influenced by foreign investors that like to see agreements that "look and feel", in many respects, as those used in other jurisdictions, but that comply with all particular formalities that need to be followed in order to execute a valid and enforceable agreement in Mexico. The following list is not aimed to cover all provisions seen in an acquisition, it is only general guideline of the provisions that are common in Mexican corporate practice; thus, counsel to the buyer (or the seller) will need to take into account the particularities of the transaction, the parties' business and its industry sector in order to determine whether other provisions should be considered for the proper protection of their client:

(a) Purchase Price, Holdback and Escrows

Although it is common practice to negotiate a purchase price in a foreign legal currency (typically United States dollars), foreign investors should take note that the Monetary Law (*Ley Monetaria*) provides that debtors of obligations agreed to by the parties in a foreign currency and payable in Mexico may discharge such obligations in Mexican pesos at the rate of exchange published by the Central Bank of Mexico (*Banco de México*) on the date when payment is made; accordingly, it is common practice for the parties to clearly set forth and agree on not only the specific method and location of payment but also the source that shall be taken and the method to be used in calculating the applicable foreign exchange rate of the purchase price.

Holdbacks, carve-outs, cash-outs and escrow arrangements, are all agreements commonly used in Mexican practice to adjust the purchase price and give the necessary certainty to the purchaser and the seller (as applicable) that sufficient funds to pay the purchase price exist, that it will receive the purchase price or that it will be timely indemnified from any losses or purchase price adjustments.

Accordingly, provisions on price adjustments are carefully drafted to provide that a post closing audit of the target company, its business or assets will be carried out, including a financial review to confirm the valuation agreed to by the parties or the existence and compliance by the target company of certain accounts set forth in its budget or business plan (cash availability, working capital, among others). It is important for the methodology of the valuation and any applicable adjustment to be clearly agreed to by the parties in the transaction documents; generally a formula is agreed to adjust the price that has been paid by the purchaser, based on a post closing audit of all or a part of the business or its assets.

In some cases, a portion of the purchase price is retained in an escrow-type arrangement in Mexico or through an escrow agreement executed in another jurisdiction, so that the purchaser has

[51] Please refer to the following judicial precedents (i) *Semanario Judicial de la Federación*, séptima época, tercera sala, tesis 93, p.251; (ii) *Semanario Judicial de la Federación*, séptima época, tercera sala, tesis 79, p.249; and (iii) *Semanario Judicial de la Federación*, séptima época, Tribunales Colegiados de Circuito, tesis 11, p.49.

access to funds to cover the price adjustment or any losses that could result in an indemnity payment under the acquisition agreement. Likewise, with the escrow in place the seller has certainty that the funds to pay the remaining purchase price exist and have been allocated specifically for such purpose, subject of course to any adjustment in the purchase price or indemnity right that the buyer may have.

(b) Representations and Warranties

It is a general practice to perform a complete legal, financial, operational and environmental due diligence of the target company before structuring the investment and closing the transaction. Even if a complete due diligence is performed, it is essential for the buyer to request extensive representations and warranties from the seller as well as for the latter to assume the obligation to indemnify the investor in the event of inaccuracy of any representation, should there be claims in the future that would affect the target company and or the acquirer of the assets.

The legal due diligence and the representations of the seller and/or the target company must at least cover the following areas:

(i) Corporate, including (1) due incorporation of the target company and its subsidiaries, (2) compliance with requirements for its operations and to conduct its business, (3) the existence of appropriate and updated corporate books and records, and (4) status of powers of attorney granted to officers and other employees involved in the company's daily activities and, specifically, of the person that is representing the sellers and/or the Company in the transaction documents.

(ii) Outstanding shares, including (1) compliance with legal requirements of all capital increases or decreases, (2) due issuance of outstanding shares, (3) evidence that the seller has title to the shares to be acquired by the investor, (4) nature of the shares to be acquired (common, preferred, non-voting, etc.), (5) existence of liens, charges or encumbrances on the shares to be acquired, (6) existence of outstanding options, rights, trust agreements, escrow arrangements or other agreements, which limit the transferability of the shares, and (7) status of dividends paid and payable on the shares.

(iii) Assets, including (1) title, (2) liens, charges, encumbrances and security interest, (3) compliance with applicable laws with regard to real estate, including environmental compliance and zoning and permits compliance, (4) existing leases, (5) fees, charges, taxes, assessments or other accounts payable by the owners, or for use of the real estate properties, (6) evidence of proper permits or authorizations from the governmental authorities, and (7) status of insurance arrangements covering the businesses' assets.

(iv) Loans and indebtedness, including (1) all existing loan agreements and other financing schemes entered into by the target companies, as lender or guarantor, (2) all credit instruments, such as promissory notes issued by the target company, (3) stand-by or other letters of credit from which indebtedness may arise, and (4) purchase agreements providing for deferred payments or detention of title.

(v) Taxes, including provision and annual payment of (1) Income Tax or the now extinct Alternate Income Tax (also known as *IETU*), (2) Value Added Tax, (3) Special Taxes on Production and/or Services, (4) Local Taxes on real estate and payroll and (5) other duties, such as import duties or water extraction duties, social security payments (*IMSS*), housing development contributions (*INFONAVIT*) and savings funds (SAR).

(vi) Transactional matters and day to day operations, including (1) all agreements entered into by the target companies, (2) major negotiations from which obligations or liabilities may arise, (3) potential events of default incurred by the target companies, (4) all relevant operational permits, authorizations and concessions (including extraction water rights), and (5) official communications from governmental authorities giving notices on irregularities or imposing fines or sanctions.

(vii) Industrial and intellectual property, including (1) trademarks, patents and trade names, (2) registrations or licenses granted thereto, (3) franchise agreements and (4) know-how and technology transfer agreements.

(viii) Environmental matters, including all applicable permits and filings and implementation of required environmental protection measures, such as (1) hazardous waste, its handling, collecting, storage, reusage, treatment and final disposal, (2) waste waters, (3) solid and liquid emissions into the atmosphere, (4) open sky combustion, (5) vehicles transporting waste, (6) independent contractors handling waste, (7) notice of emissions and water treatment.

(ix) Labor matters, including (1) collective bargaining agreements, (2) individual labor contracts, (3) executive compensation arrangements of any kind, (4) maintenance of appropriate joint commissions records and (5) labor inspections.

(x) Disputes, including (1) actual, pending or threatened claims involving the target companies, whether in judicial proceedings, administrative proceedings or other dispute resolution mechanisms, such as arbitration, (2) existing court orders or arbitral awards, and (3) settlements.

When possible representations and warranties must not be in lieu of the due diligence review, because such due diligence would be always limited in the time and in depth of the analysis. As in other jurisdictions, the representations and warranties must be drafted based on the results of the due diligence carried out by the purchaser or investor.

Sellers should seek that representations and warranties from purchaser focus on the capacity of the purchaser or its affiliates to assume its obligations under the transaction documents and to perform them accordingly, including buyers' financial capacity to pay the purchase price at closing (whether with its own funds or through financing commitments).

The survivability of the representations and the relevant indemnities given by the seller as to such representations are generally framed to cover a convenient period of time, in some cases to cover the statute of limitations (applicable to matters that relate to title of the assets being sold[52], capacity of the parties,[53] as well as environmental[54], labor[55] and tax matters[56]) and in other cases with a survivability that ranges between one and two years after closing. As in other jurisdictions, representations and their survivability are linked to a default provision by which misrepresentations could trigger certain penalties that could not only include a monetary indemnity but also an early termination right.

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[52] Pursuant to the Federal Civil Code, the acquirer has an indemnification right against the seller in the event of a lawful dispossession of the acquired assets and the relevant statute of limitation is ten years as of dispossession date. For additional information, please refer to articles 2119, 2126, 2127 and 1159 of the Federal Civil Code.

[53] Pursuant to the Federal Civil Code, the lack of capacity of one of the parties constitutes a cause of relative nullity and its statute of limitation is ten years. For additional information, please refer to articles 2224 – 2242 and 1159 of the Federal Civil Code.

[54] Pursuant to applicable environmental laws, the statute of limitations for liability resulting from damages to the environment is of twelve (12) years as of the date in which the environmental damage was caused and its effects were known. The statute of limitations for liability resulting from breach of administrative provisions in environmental law that do not cause damages to the environment (i.e., failure to renew an environmental permit or to file an environmental report, etc..), is of five (5) years.

[55] Generally, the statute of limitation for labor actions is one year as of the day following the date on which the labor obligation is due and payable. However, please bear in mind that the Federal Labor Law provides other statutes of limitations applicable to specific labor actions. For additional information, please refer to Articles 516, 517, 518 and 519 of the Federal Labor Law.

[56] The general statute of limitations applicable to tax liabilities is five years as of the date on which the tax obligation is due and payable. However, the tax liability's statute of limitation will be equal to ten years if the target (i) is not registered before the Tax Payers' Registry (*Registro Federal de Contribuyentes*), (ii) does not keep accounting records; and/or (iii) have not filed the relevant tax returns. For additional information, please refer to Article 67 of the Tax Federal Code.

(c) Pre-Closing and Post-Closing Covenants

Pre-closing and post-closing covenants of the parties in a Mexican transaction are those commonly used in other jurisdictions.

Prior to closing parties should focus on covenants aimed to assure that the parties will collaborate and take all necessary steps required to obtain and fulfill closing conditions. More importantly, stand still provisions regarding the conduct of business between signing of the acquisition agreement and closing of the transaction with respect to the target company, its assets and business are common practice. In them, buyers mostly request to be notified of certain business activities or transactions to be carried out by the target company or its affiliates beyond the business' common past practice or that exceed predefined thresholds. The scope of these stand-still covenants depends in the industry and sector of the target, but they are used by practitioners in both asset and stock transactions.

Post-closing covenants are generally driven by closing conditions agreed to by the parties. A specific post-closing covenant found in Mexican stock purchase agreements is related to income tax payable by the seller on the purchase price. This is of particular interest to the purchaser since the target company (issuer of the sold shares) may be held jointly liable with the seller for income tax payable on any capital gain of the seller upon receipt of the purchase price. To such an effect, it is common to include a post-closing covenant to the seller whereby it agrees to deliver copy of any tax documentation which evidences the payment of Income Tax derived from the sale of stock, including the corresponding tax return and any ancillary documentation filled in such respect before the Mexican Tax Authorities.

(d) Conditions to Closing

In most cases, an investment is carried out first by executing a stock purchase (or subscription agreement) or the asset purchase agreement and subsequently, by having the typical closing at which time the investor will pay the purchase price and receive the purchased asset only if certain closing conditions are met.

It is common for Mexican company's by-laws to require previous corporate authorizations from the shareholders' or its board for a company to sell its assets that conform a business. The same is sometimes true for the sale by shareholders or partners of their interest in the business entity. In addition, when contemplating a stock purchase agreement the parties should review whether or not the existing shareholders or partners need to waive any right of first refusal or right of first offer that may exist; furthermore, certain formalities as to the conveyance of shares in a Corporation or a Limited Liability Company will need to be included as a closing condition, such as the registration of the transfer in the entity's corporate books and, in the case of a Corporation, the delivery of endorsed share certificates to the buyer.

If as a result of the due diligence problems are identified, corrective measures may sometimes need to be taken before closing the investment. Accordingly, provisions can be carefully drafted in the agreement to establish obligations to correct any problems. Such provisions generally take the form of conditions to closing, so that at the time of making the investment, such problems are solved or the correction measure is waived by the acquirer. Special care should be taken when drafting such conditions in order for them to be valid and enforceable under Mexican law; for example, counsel should keep in mind that the fulfillment or compliance of such conditions do not unilaterally depend on one of the parties to avoid any risk of such condition being rendered null and void.

In both stock and asset acquisitions –as in other jurisdictions- additional closing conditions could consist on buyer completing its due diligence process, the accuracy of representations and warranties made by either party, the parties obtaining antitrust approvals, third party consents (from clients or suppliers) or other governmental approvals or the execution of other transactional agreements (*i.e.*, shareholders' agreements, stock options, license agreements, services agreements, and transition agreements).

Please also refer to Sections 1. and 2., above for a more complete description of the most common closing conditions seen in Mexico under each scenario (assets and stock acquisition).

(e) <u>Indemnification Provisions</u>

Indemnification provisions are common practice in Mexican transactions. Generally, such provisions set forth the parties' right to be indemnified for damages and lost profits (*daños y perjuicios*) arising from (i) any breach of the representations contained in the agreement, (ii) any breach of the covenants set forth in the agreement, and (iii) specific relevant issues not covered by the representations or that may require a particular indemnity provision (*i.e.*, resolutions on pending legal proceedings, tax and environmental issues identified during due diligence). An important basic concept as to seeking performance of indemnity provisions in Mexico is that damages and/or lost profits must be a direct and immediate consequence of the other party's breach in its obligation; since not every breach of an obligation results in an immediate damage or loss, not all breaches result in an indemnity obligation.[57]

As in other jurisdictions, the indemnification clause is usually one of the most important provisions of any acquisition agreement and frequently results in intense negotiations between the parties; hence, no standard indemnity provision exists for Mexican acquisitions. Accordingly, please note that deminimis amounts or deductibles (*i.e.*, a minimum amount that shall be exceeded before any indemnification right is owned by the indemnifying party) and capped indemnities (*i.e.*, a maximum amount to be indemnified) are common practice in Mexico as are the survivability of any indemnity for a misrepresentation (please refer to paragraph 4(b) above).

Finally, with respect to the indemnification provisions, counsel should keep in mind that these provisions are an elementary clause of the agreement because Mexican statutory dispositions do not provide a suitable protection in the event of a breach to the representations contained in the agreements subject to Mexican Law.

(f) <u>Applicable Law</u>

Under Mexican Law, the Corporation and Limited Liability Company are governed by Mexican Law, as well as their relevant by-laws. Consequently, in most cases, Stock Purchase Agreements, Subscription Agreements or Shareholders' Agreements should also be governed by Mexican Law to avoid inconsistencies. Having said this, it is not all that uncommon for the agreements of certain cross border stock transactions to be governed by foreign law.

Even though parties are allowed to submit the stock or asset acquisition agreements to a foreign law[58], the following restrictions should be taken into account: (i) foreign law shall not be applied in Mexico if its provisions are contrary to Mexican public policy (*orden público*);[59] (ii) the foreign law agreed between the parties shall not be applied in Mexico if the parties have selected the applicable law in order to avoid general principals of the Mexican Law;[60] and (iii) real estate properties shall be governed by the applicable law of their location.[61]

(g) <u>Dispute Resolution</u>

With respect to dispute resolution, arbitration clauses are a common feature in SPAs and other M&A related agreements. Arbitration is now the preferred dispute resolution mechanism for M&A transactions in Mexico, as an alternative to court litigation. Arbitration has proven to be an effective way to solve disputes at every stage of an M&A transaction due to certain advantages that go from the

[57] Article 2110 of Federal Civil Code.
[58] Article 12 of the Federal Civil Code.
[59] Article 13 of the Federal Civil Code.
[60] Article 13 of the Federal Civil Code.
[61] Article 121 of the Political Constitution of the Mexican United States (*Constitución Política de los Estados Unidos Mexicanos*).

possibility for the parties to select a specialized arbitration tribunal with knowledge of the industry and the economic implications of the transaction, to the advantage of confidentiality in a very sensitive industry. Although as mentioned above Mexican law is usually the applicable law to the transaction and the dispute, an arbitral tribunal can decide a dispute under a foreign applicable law, which is more common in cross-border transactions and usually involves an arbitral proceeding with more than one language.

Arbitration is also the preferred dispute resolution mechanism for M&A transactions because it is more business-friendly, allowing the parties to resolve their disputes while disrupting in the least possible way their business relationship in an industry where parties are likely to keep doing business together after a dispute is over. It is also important to note that, in most cases, parties are able to settle their disputes by other types of alternative dispute mechanisms, such as negotiation or mediation, before the rendering of an arbitration award.

The types of M&A disputes vary, and are generally catalogued in either pre-closing disputes (mostly related to an MOU/LOI, due diligence issues, confidentiality or exclusivity agreements, etc.), or post-closing disputes (mostly related to representations and warranties, price adjustments, review of expert determinations, put and sales options, etc.). M&A disputes can be complex because they usually involve many ancillary interconnected agreements, which often include a similar arbitration clause, and many different parties. These types of disputes are easier to handle in arbitration than in litigation.

Although, as mentioned above, most arbitration disputes do not get to the award rendering stage, it is important to note that Mexico is a pro-arbitration jurisdiction and Mexican courts are more prone to enforce arbitration awards. The Mexican arbitration law (included in the Commercial Code) is based on the UNCITRAL Model Law and Mexico is a party to the New York and Panama conventions for the recognition and enforcement of foreign arbitral awards.

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